Internal Revenue Servi

memorandum

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Br3:ELBerkowitz

date: OCT 23 1991

to: William E. Bonano, International Special Trial Attorney W:SF

from: Bernard T. Bress, Senior Technical Reviewer CC:INTL:Br3

subject: [redacted]
Request for Informal Technical Advice

This is in response to your request for informal technical advice concerning the scope of the section 367 ruling issued to [redacted] on [redacted]. You requested that we provide you with guidance on what is a sale "into the United States," as the phrase was used in the ruling.

Your question reflects the fact that a concluding caveat in the private letter ruling issued to the taxpayer states that sales into the United States may require an adjustment under section 482 to reflect the value of royalty payments due. By phrasing the issue in this manner, the taxpayer is attempting to limit the issue to deciding whether the sale to [redacted] is a sale into the United States. The issue cannot be so limited because section 367(a) and Revenue Procedure 68-23 restrict the rights that can be transferred to a foreign subsidiary, and those restrictions were fully reflected in the private letter ruling. To the extent that rights could not be transferred, those rights are retained in the United States, and the United States parent must be appropriately compensated for any use of those rights.

Section 367(a), as in effect for [redacted] (the year in which the [redacted] technology was transferred from [redacted] to [redacted]), provides that in determining the extent to which gain shall be recognized on a section 351 transfer, a foreign corporation shall not be considered to be a corporation unless it has been established to the satisfaction of the Secretary that such exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes.

Revenue Procedure 68-23 sets forth guidelines for advance rulings under section 367. The goal of this revenue procedure is to implement the tax avoidance purpose language of that section. Section 3.02(1)(b)(iii) of Revenue Procedure 68-23 provides that a favorable ruling under section 367 will not be

issued for a section 351 exchange where the property to be transferred to the foreign corporation is "United States patents, trade-marks and similar intangibles to be used in connection with (1) conduct of a trade or business in the United States or (2) the manufacture in the United States or a foreign country of goods for sale or consumption in the United States" (Emphasis added).

Revenue Procedure 68-23 thus preserves nonrecognition treatment with respect to the transfer of the right to manufacture solely for sale or consumption outside of the United States. The private letter ruling consequently reflects the taxpayer's representation that [redacted] transferred to [redacted] the right to manufacture [redacted] in [redacted] solely for sale or consumption outside of the United States.[1]/ This transfer was permitted by the revenue procedure, because the rights transferred were only foreign rights: that is the rights to manufacture for sale or consumption outside the United States. Under the revenue procedure, [redacted] could not, and therefore did not, transfer the rights to manufacture for sale or consumption in the United States. Therefore, when [redacted] made sales to [redacted] for United States consumption those sales used rights that had not been transferred to [redacted], the right to make sales for United States consumption. Thus, [redacted] must be compensated for the use of that right and an appropriate royalty must be determined under section 482.

In interpreting the language of Revenue Procedure 68-23, we should first look to the plain meaning of the language used in that document. The revenue procedure prohibits manufacturing for "consumption in the United States": this language on its face covers any situation in which the goods are returned to the United States for consumption here, such as the [redacted] transactions at issue here. By focusing on consumption, the revenue procedure sought to identify the market in which the economic value of the intangible was being exploited; since it is consumption that creates demand, the location of consumption will indicate the location in which

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[1] Page 3 of the private letter ruling contains the representation that "[n]one of the property transferred by [redacted] to [redacted] was property described in section 3.02(1)(a) or (b) of Rev. Proc. 68-23, 1968-1 C.B. 821." The prohibition on the transfer of rights to manufacture for sale or consumption in the United States was contained in section 3.02(1)(b), quoted above. Thus, taxpayer expressly represented in connection with the ruling request that it had not transferred to [redacted] any right to manufacture for sale or consumption in the United States.

value is being derived. This analysis is supported by the logic of the section 367(a) tax-avoidance analysis; where the consumption and therefore the exploitation of an intangible take place in the United States, and give rise to income that would otherwise be taxable in the United States, permitting that intangible (and the income associated with it) to be transferred overseas would give rise to avoidance of United States tax. Therefore, such a transfer should be, and is, prohibited under the Service's implementation of section 367 in Revenue Procedure 68-23.

Further, this reading of the revenue procedure is fully consistent with other authorities that use remarkably similar language; indeed, it seems likely that the drafters of the revenue procedure were drawing upon those authorities, which operate in a similar manner and for similar reasons. Thus, a number of other Code provisions that seek to identify the substantive economic locus of sales activity refer to sales "for use, consumption, or disposition" in a particular location.[2]/ This language is used to limit taxpayers' ability to attribute income to geographic locations outside those in which income is substantively being earned; thus, the language is used to backstop the geographic tests that define foreign base company income and those that define the existence of an export sale.[3]/

For example, Subpart F taxes foreign base company sales income to the U.S. shareholder of the controlled foreign corporation (CFC) that earns that income. Foreign base company sales income includes income earned by a CFC from the resale of property purchased from a related person if the CFC is incorporated in a jurisdiction that is neither the place where the goods were manufactured nor the place where they were consumed. Congress's intent was to prevent taxpayers from isolating sales income in low tax jurisdictions that had no other connection with the transaction. Thus, foreign base company sales income would include sales income derived from the purchase of property by a controlled foreign corporation from a related United States manufacturer, followed by a sale to an unrelated person with direct shipment to the United States for ultimate consumption. Failure to apply the base company rules in this scenario would permit taxpayers to do exactly what Congress sought to prevent; that is, to realize sales income in a geographic location having negligible

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[2] See sections 864(c)(4)(B)(iii); 865(e)(2)(B); 904(d)(2)(G); 927(a)(1)(B); 954(d)(1)(B); 993(c)(1)(B); 994(c); 971(b)(1); 971(c)(2); 971(c)(4).

[3] See sections 1.864-6(b)(3)(ii)(a); 1.927(a)-1T(d)(1)(i); 1.954-3(a)(3)(ii); 1.971-1(b)(1)(i); 1.993-3(d)(2)(i).

economic relationship to the income, for tax avoidance purposes.

Similarly in section 367, Congress was concerned with taxpayers transferring assets out of the United States with a view to avoiding U.S. tax. One way in which taxpayers would seek to do so was by transferring intangibles out of the United States into low tax jurisdictions and then selling the finished product back into the United States. The revenue procedure's rules dealing with the transfer of intangibles under section 367(a) were intended to prevent precisely this kind of tax avoidance. Taxpayers were not permitted to transfer the right to manufacture for sale or consumption in the United States. If sales are tested for this purpose solely by the place of sale, then taxpayers can avoid the application of section 367(a) by doing precisely what [redacted] did: transfer the right to make foreign sales to a foreign subsidiary, sell to a foreign subsidiary of a United States company, and ship into the United States for use in the United States. Looking only to place of sale would effectively eliminate the requirement that goods not be consumed in the United States and undercut a significant portion of the intended scope of section 367(a). Accordingly, in determining whether property is sold or consumed in the United States the language of Revenue Procedure 68-23 should be read in a manner consistent with the similar language of section 954(d)(2)(B). As a result, these types of U-Turn sales would not be insulated because they are an attempt to rely upon a geographic misattribution of income to carry out a tax avoidance scheme prohibited by section 367 (a) and Revenue Procedure 68-23.

It may be argued that applying the consumption test would be problematic in this instance since it may not be known where [redacted] eventually sold the computers containing the [redacted]. However, there is substantial authority for the view that the most reasonable method of determining where a purchaser uses goods is to look to the place where those goods are delivered. Other provisions that refer to sales "for use, consumption or disposition" have been consistently interpreted to mean the place of delivery or "destination."[4]/ Accordingly, for purposes of applying the

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4 Section 1.954-3(a)(3)(ii) provides that, as a general rule, personal property which is sold to an unrelated person will be presumed to have been sold for use, consumption, or disposition in the country of destination of the property sold.

Section 1.993-3(d)(1)(i) in general provides that property cannot qualify as export property unless it is sold or leased for direct use, consumption, or disposition outside the United States. Property is sold or leased for direct use, consumption,

relevant limitations of Revenue Procedure 68-23 it should be sufficient to establish that the [redacted] in question were shipped for delivery in the United States. Their United States destination would support the conclusion that they were shipped for U.S. consumption, and that such shipments therefore involved the use of rights not held by [redacted], requiring the payment of a royalty to the holder of those rights.

In essence, the taxpayer is arguing that the private letter ruling eliminates the requirement that the property be consumed outside the United States; therefore, only the sale need be outside the United States. Because the sale took place in [redacted], the sale is outside the United States. For the reasons set forth above, the taxpayer's argument is totally inconsistent with the facts it represented to be true in connection with the private letter ruling. Thus, the private letter ruling did not (indeed, could not) put any substantive limitations on the Internal Revenue Service's ability to make section 482 adjustments with respect to rights that were not transferred under section 367(a). Further, the language in the private letter ruling was merely a caveat; it was simply a short-hand method of referring to the substantive limitations on the taxpayer's ability to transfer rights relating to manufacture for sale or consumption in the United States. Thus, the short-hand reference to transfer "into the United States" must be read in light of, and in a manner consistent with the underlying substantive limitation of the revenue procedure Accordingly, even if the language of the private letter ruling's caveat were to be given controlling weight, it would have to read to cover any sales or consumption in the United States consistent with the underlying substantive rule.

Finally, even if the language of the caveat is given controlling weight and the substantive limitations on that language contained in the revenue procedure are ignored, as a substantive matter there were sales into the United States. The private letter ruling does not define the phrase "sales into the United States." The most logical interpretation of that language would be that a sale is a sale into the United States if the property sold was delivered into the United States. This would be consistent with the purpose of section 367(a) and would incorporate both prohibitions contained in the revenue procedure. Thus, even if the caveat

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or disposition outside the United States if such sale satisfies the destination test. Section 1.993-3(d)(2)(i) provides that the destination test is satisfied only if it is delivered by such seller or lessor regardless of the F.O.B. point or the place at which title passes or risk of loss shifts from the seller or lessor for ultimate delivery outside the United States.

is applied narrowly and literally the caveat would permit the appropriate section 482 adjustments.

If you have any questions or desire additional information, please do not hesitate to call me or Leslie Berkowitz at (202) 566-3452.

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